

# BANK REGULATION AND BANK PLANNING

REMARKS BY

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Chief Executive Officers' Program  
American Bankers Association

Boca Raton, Florida

February 17, 1974



AG 2567  
53A2  
2/17/74

I am pleased to be here in Florida and to be able to participate in this program. The ABA has organized an excellent agenda that will certainly benefit your banks and, through them, your communities.

My topic today concerns bank regulation. Regulation in all its dimensions is part of the environment in which you operate, and changes in regulation must be considered in your planning. In part, my focus will be on recent and proposed legislation and regulation, especially those developments which involve the Federal Reserve System. I also propose to look at the changing practices and technology of the financial system inasmuch as these changes generate pressures for new legislation. Major regulatory changes are not accidents of the legislative process; rather they reflect more fundamental changes and needs in the economy. Therefore, by looking at the existing cost pressures and technological developments in the financial system, you can better assess the future regulatory framework and its influence in your planning.

### **Bank Holding Company Act**

Let me begin by looking at some recent legislation which is changing the character of American banking. Specifically, I have in mind the 1970 amendments to the Bank Holding Company Act.

Since I have advanced the proposition that legislation reflects changes in the financial system, what were the economic forces at work in this instance? The Bank Holding Company Act passed in 1956 applied only to corporations which controlled two or more banks—one-bank holding companies were exempt. The Act required multi-bank holding companies to divest their nonbank subsidiaries, but did not impose similar requirements on the one-bank

companies. This exemption was important, because it permitted important banking innovations to be made.

In the 1960's, the financial environment was affected by innovations in both technology and management practices. Banks turned to liability management, whose most obvious form is the certificate of deposit. Twenty years ago bank competition for deposits was relatively passive, whereas now banks actively bid for them. Banks also found that forming a holding company brought important benefits. As long as only one bank was involved, the restrictions of the Bank Holding Company Act did not apply. During the brief period in the late 1960's when they were free of regulation, these newly-formed one-bank holding companies began to issue their own commercial paper, in the manner of large corporations. They began to expand in other fields, some related to banking and some not, and to expand these non-banking activities across state lines.

By the end of the 1960's, banks were actively developing new management techniques, new financial instruments, and new services. These spilled over the boundaries of traditional banking through the device of the one-bank holding company. The legislative response to these developments was the passage of the 1970 amendments to the Bank Holding Company Act.

This legislation in a sense was restrictive, but by formalizing new ground rules for nonbank acquisitions, it opened up opportunities for the nation's banks. Congress attempted to balance the benefits of increased competition in new services against the dangers of undue concentration of power.

This legislation has opened a new phase of development in the nation's financial system. Congress recognized the advantages of controlled expansion to exploit new technology and to increase competition, and it did not attempt to turn back the clock.

The Act assigns to the Federal Reserve Board the responsibility for determining permissible activities. To date, eleven non-bank activities generally open for holding company subsidiaries have been approved by the Board, and other activities are under consideration. The leading fields, in terms of entry or acquisition applications, are mortgage banking, consumer finance and credit insurance. Other important fields include the leasing of personal property, investment advisory services and data processing. At the same time, the Board has specifically listed eight activities as not permissible.

Approved activities must meet the standards set forth in Section 4(c)(8) of the Act: The proposed activity must be so closely related to banking as to be a proper incident thereto. Most of the activities approved in 1971 were closely related to traditional banking—mortgage banking, consumer finance and so on. More recently, approved activities have been less obviously part of regular bank services, for example courier services, and credit insurance underwriting. The Board has felt these activities provided benefits to the public, either in greater convenience or more competition. This approach recognizes the changing nature of the banking business.

The Board has denied activities on grounds that they are not closely related to banking or where there might be problems of undue concentration of conflicts of in-

terest. For example, operation of a savings and loan association by a bank holding company is not on the permissible list, but it is being reconsidered. Savings and loan associations are closely related to traditional banking, but they also are competitors whose acquisition might create problems of undue concentration. At the moment, this question has not been settled.

### **Implications of Holding Companies**

In planning for your bank, consider whether the bank holding company organization can be profitably utilized. The larger bank holding companies have been actively expanding, but small banks should not neglect the opportunities open under this Act. Examine both local markets and the skills present in your bank. For example, mortgage banking and consumer finance are fields to which some banking skills can be applied. Remember that in many respects subsidiaries of a holding company have more flexibility than a bank, or a bank affiliate. The holding company subsidiary is not subject to state banking regulation. Moreover, it can expand across state lines with greater certainty and freedom of action than direct subsidiaries of banks themselves.

If an opportunity exists, and your bank does not jump at it, then don't be surprised if other organizations move in. In unit banking or limited branch banking states, competition in consumer and mortgage lending can arise from nonbank subsidiaries, even though competition from new banks is limited. The point is, look over the list of approved activities for bank holding companies and see if they offer opportunities for you.

In terms of the specifics of expansion into permissible fields, *de novo* entry is the

easiest way to secure regulatory approval. Basically all that is required is publication of a notice describing the proposed activity and notification of the local Reserve Bank. This approach has the disadvantage of requiring you to build up a new organization, but it may be possible to acquire people with the appropriate skills. Regulatory approval of the alternative approach of acquiring a going concern is less certain. Generally approval can be expected if the acquired firm and the bank are not direct competitors, although large banks sometimes face questions about undue concentration. Denials, when they occur, are usually the result of financial problems, such as insufficient capital.

Acquisition of a firm in the same market as the holding company's bank, however, always faces the prospect of denial on grounds of elimination of competition. To obtain approval in these circumstances, you must demonstrate that the acquisition will result in some positive public benefit or increased ability to compete with other larger banking organizations in the same market. Being a small bank will not prevent a denial if the local market is small and there are few competing banks. In brief, *de novo* entry faces lower regulatory barriers than acquisition.

One final suggestion. Do not drop an activity you think you could successfully offer just because the activity is not on the approved list. If you think it fits the statutory requirement of being closely related to banking, apply to engage in the activity. I know of an application submitted recently by a small bank holding company in my District and now pending before the Board. The subsidiary bank had \$30 million in deposits, and the holding company applied to form a subsidiary which would act as a dealer in municipal bonds serving

other small banks in its region. This provides a good example. If you have a promising idea, then discuss it with your District Reserve Bank staff, and if it appears acceptable, go ahead and apply. Why wait for the big banks to act if you have a good idea?

To summarize, the Bank Holding Company Act offers an opportunity for banks to diversify and expand their activities. You should not regard the Act as something just for big banks. There are many banks which can use the holding company as a means for better utilizing their management and their capital. Look into the opportunities for expansion of services that are appropriate to your resources and skills.

### **Uniform Reserve Requirements**

Now let me turn to a proposal for new legislation, the recent Federal Reserve proposal for uniform reserve requirements. The proposal would apply Federal Reserve regulations for reserve requirements to demand deposits at nonmember banks, and to the negotiable orders of withdrawal (NOW accounts) offered in New England by mutual savings banks. Savings and time accounts of nonmember banks would not be affected; they would continue to be set by state regulation. The purposes of the proposal are to strengthen monetary control and to reduce inequities between member and nonmember banks.

This proposal, it should be emphasized, does not mandate compulsory System membership. It is limited to those deposits which effectively serve as money. Just as a historical note, this objective was almost achieved forty years ago. The 1933 legislation establishing the FDIC required nonmember insured banks to join the Federal Reserve System, but this provision was repealed in 1935.

The reason for the uniform reserve proposal lies in trends in the banking system. Thirty or forty years ago, this legislation would not have been needed. But the proportion of demand deposits held by nonmember banks has increased to the point where the effectiveness of monetary policy is being affected. Since 1960, approximately 750 banks have left the System and about 960 out of 2700 newly chartered banks have joined. But only 92 were state banks—867 were national banks for whom membership is mandatory. Thus, 1,742 of the new state banks became nonmembers. In the same period, the demand deposits held by nonmember banks grew by 164 percent, while those held by members increased only 61 percent. In 1960 nonmember banks controlled 17 percent of demand deposits, but by the end of 1973, their share was approximately 25 percent. Add to this situation the prospect of more savings institutions offering accounts with third party payment features. These accounts serve as an effective substitute for demand deposits at commercial banks, and they represent deposits outside the direct monetary control of the Federal Reserve.

Again trends in the financial system point to the need for new legislation. Unlike banking of the 1930s and '40s, when excess reserves were a sign of prudent management, contemporary bankers count the costs of their reserve requirements and manage their reserves as carefully as other assets. For smaller banks, cost considerations do not favor Federal Reserve membership. I do not think cost trends will be reversed, and therefore, the prospect is for a continued increase in nonmembers' share of demand deposits.

The advantage of state nonmember status rests upon the fact that state reserve requirements are effectively lower than

System requirements. States permit reserves to be held as deposits at correspondent banks, and in some cases, with regard to time deposits, in earning assets such as U.S. government securities. The balances held as correspondent deposits serve two purposes: they meet reserve requirements and they compensate the correspondent bank for various services provided to the nonmember banks. Member reserves serve only the first purpose, and additional assets must be allocated as correspondent balances. Cost differences explain the trend away from membership.

The growing share of deposits in nonmember banks weakens monetary control because deposits in correspondent banks, unlike deposits at a Federal Reserve Bank, can support lending by the correspondent bank as well as serving as legal reserves for the state banks. Therefore, reserves flowing into nonmember banks, under present arrangements, can support more deposits and lending than they would if they went initially to member banks. The Federal Reserve through its open-market operations changes the reserve base of the banking system, but the effect of any open-market transaction depends upon the proportion of the proceeds appearing as nonmember deposits. This proportion is not predictable and at times it has been quite large. Under such conditions, monetary control becomes more difficult. The obvious way to remove this source of uncertainty is to have uniform reserve requirements on all types of demand deposits.

Adoption of uniform reserves for demand accounts and NOW accounts would improve monetary control by strengthening the link between the supply of reserves controlled by the Federal Reserve and the nation's money supply. In the absence of uniform reserve requirements, the man-

agement problems of the Federal Reserve can only increase to the detriment of the whole economy.

That is why the Federal Reserve has asked Congress to impose uniform reserve requirements. This is not an attempt to undermine the dual banking system, or to bring about compulsory Federal Reserve membership. In fact, the legislation is designed specifically to achieve the maximum benefits in terms of improved monetary control with minimum disruption of the state banking system.

### **Easing the Burden**

In particular, several features of the proposal are designed to ease the burdens on nonmember banks:

—Savings and time accounts would not be subject to the uniform reserves. State rules would continue to apply. On economic grounds, demand deposits are the prime target of control, not time accounts. This same consideration excludes controls over the bulk of the accounts in savings and loan associations and mutual savings banks.

—The first \$2 million of net demand deposits would be exempted from Federal Reserve control. With the exclusion of time accounts, this would mean most banks below \$4 million in deposits would not be affected by the uniform reserve proposal. This exemption amounts to about 38 percent of present nonmember banks, although only a nominal part of total demand deposits. In addition, there is a large group of banks for whom their existing vault cash is sufficient to meet System requirements. When you allow for all these banks, only about 3,500 of some 8,700

nonmember banks would have to keep deposits at the Federal Reserve Banks.

- As compensation for increased costs, nonmember banks would have access to the discount window on similar, though not identical, terms as member banks.
- Finally, there would be a four-year transition period before full reserve requirements would come into effect.

The proposed legislation contains other features, but the net effect is to exempt the smaller nonmember banks. It is not intended to erode the incentives to hold state charters. There would be no major change in the existing supervisory powers of state or other regulatory bodies. The Federal Reserve would be concerned only with insuring that proper reserves are held, and it would not exercise any other supervisory functions over member banks.

Most of the nation's banks recognize the need for effective monetary control, and accordingly they should support this proposal. Uniform reserves applied in the way specified by the legislation would represent a major gain for monetary policy.

There also are considerations of equity. The proposal would remove some of the competitive disadvantages that the smaller national banks bear compared to similar nonmember banks, as to the effective cost of reserve requirements. The opposite side of the trend to more nonmember banks is a trend to a large-bank national banking system. A proper dual banking system should more closely balance the relative attractions of national charters for small banks. At the moment, the benefits as they involve reserves favor state charters for small banks.

Finally, you should all consider the long-run benefits of establishing the principle that all accounts which serve as money should be subject to the same reserve requirements. If NOW accounts or their equivalent accounts spread throughout the savings and loan industry, these institutions would have considerable competitive advantages over commercial banks—nonmember banks as well as members—under present rules. Savings institutions would have lower liquidity requirements, and they would be able to pay interest on the equivalent of demand account. Consider the competitive consequences of such an arrangement. Competitive equality and more effective monetary control both point to the need for uniform reserve requirements.

### **Hunt Commission Proposals**

The President's Commission on Financial Structure and Regulation, better known as the Hunt Commission, released its report in late 1972. It proposed a package of legislation which would bring about a far-reaching rationalization of the nation's financial system. Its general aim was to increase the flexibility of the financial system, provide more competition among the nation's financial institutions, and impose less regulation. The Commission regarded its recommendations as an inter-related package. Losses from one proposal might be offset by gains in another, but overall the benefits would be positive when judged by the whole package. The major proposals were:

- 1) to phase out interest ceilings on time and savings accounts;
- 2) to permit thrift institutions to offer third-party payment services;
- 3) to require that all institutions offering

checking accounts become members of the Federal Reserve System;

- 4) to grant expanded lending and investment powers to thrift institutions and banks; and
- 5) to provide more uniform tax treatment of various lending institutions.

As the situation now stands, it appears likely that the Hunt Commission's proposals will not be adopted as a package. The Administration submitted its own proposals in the Financial Institutions Act of 1973 last summer. While these follow the Hunt Commission in part, they add some new features. Nonetheless, an element common to both is the prospective grant of more power to thrift institutions while removing some of the present regulatory and tax advantages these institutions enjoy. However, the savings and loan industry appears to be unwilling to give up its present tax arrangements and its present interest advantage on savings accounts in return for broadened lending and investment authority and third-party payments powers. Moreover, Congress itself has shown little inclination to move in the direction recommended by the Hunt Commission. Instead of broadening the lending and investment powers of the nation's financial institutions, Congress seems inclined to impose more rigid portfolio specifications, including compulsory allocation of funds to specific sectors, for example, by the allocation of a fixed percentage of assets to residential mortgages.

In the absence of a unified package of institutional reforms, we are likely to see a piecemeal approach which could be detrimental to some, if not all, financial institutions. It appears that everyone is in favor of the market mechanism as a

foundation for the financial system in the abstract; but the ultimate effects of increased reliance on the market are sufficiently uncertain that few are willing to rationalize the existing welter of obscure costs and benefits, including subsidies, which are implicit in differential reserve, tax and other regulatory treatment.

### **Outlook for New Legislation**

Despite the uncertainties in this situation, I would like to assess the prospects for new legislation and regulations. I think that the Federal Reserve System's request for uniform reserve requirements will be seriously considered by Congress, and its chances for adoption will improve with time. This reasoning is related to another expectation, namely that thrift institutions eventually will offer a wide range of third-party payment services. Like those currently provided by nonmember banks, such services could have a significant monetary impact. This consideration again underscores the need for uniform reserve requirements on institutions offering comparable payment services.

Communication systems are beginning to make point-of-sale terminals economically feasible. When such a system is tied to the retail level, considerations of economics and competition (including the probable stance of the Justice Department) will point to the participation of as many institutions as possible—S & L's as well as commercial banks. If you don't think electronic systems of some kind are coming, look around today. You will see 24-hour national authorization systems coming on-line for bank credit cards, and remote banking facilities appearing and being tested by savings and loan associations. Some of you may have noticed reports of successful experiments by a Nebraska sav-

ings and loan with remote terminals at supermarkets.

The Federal Home Loan Bank Board now permits Federal S&L's to install remote terminals in merchant locations within their market areas without specific Board approval. The Home Loan Bank Board also is considering allowing automated tellers and cash dispensing machines to be installed without requiring an application, which seems to me to be a good substitute for actual branching. The extension by regulatory authority for S&L's to credit merchant accounts directly also may be imminent.

In short, it is conceivable that the S&L's may bypass the checking account entirely and jump directly into third-party clearing. This would enable these nonbank financial institutions to compete in the trade area of smaller commercial banks, and to offer deposit and withdrawal services by means of electronic transfers comparable to the bank services offered through the medium of checks. Moreover, their cost of electronic-transfer services would be significantly less than the cost of check processing.

The Federal Reserve System has proposed amendments to its Regulation J to set up rules for automatic or paperless transfer of funds. Under these proposals, member banks could send and receive electronic funds transfer transactions having many of the characteristics of checks. Such "debit transfers" could be transmitted nationwide by the electronic telecommunication system operated by the Federal Reserve. Settlement usually would occur on the same day the debit was transmitted. Pre-authorization would be required for these debits, and in this sense the "debit transfers" are similar to the transactions now

processed by automated clearing-houses in California.

In these areas, the paperless deposit of paychecks is a reality, and banks are looking into procedures for eliminating all or part of the paper involved in processing such recurring payments as utility and department store bills. This system would offer important advantages to member banks. As for nonmember-bank access to these transfer facilities, it may be wise to have them go through their correspondents or be subject to higher fees than members.

The various pieces needed for a full electronic payments system exist. It only remains for them to be put together as an economic proposition. When that system is operational, regulations will be changed to reflect it. I think third-party payment privileges, regardless of what they are called, will be given to thrift institutions and that uniform reserve requirements of some kind will go along with them.

On the lending side, it is also probable that thrift institutions will be given more powers, particularly in the consumer-lending area, but for the moment, any expansion will be hedged by concern about protecting housing finance. As part of this hedging tendency, interest-rate ceilings will be retained for the moment, but in time I think they will disappear. Their disappearance will be hastened by the appearance of new market instruments which increasingly will be consumer-oriented, such as small denomination savings bonds issued by nonfinancial corporations. These developments seem certain to result in less reliance by the thrift institutions (and the banks) upon traditional passbook savings accounts, and more reliance upon such instruments as mortgage-backed bonds,

which can be authorized under existing Home Loan Bank Board authority.

Thus, the aim of the Hunt Commission—greater flexibility for the nation's financial system—will be achieved only slowly and partially by developments in the market and at the regulatory level. Rigid rules do harm, because they reflect past social priorities which may not be the same as today's and tomorrow's priorities, and thus they impede adjustment to new needs.

### **Conclusion**

In conclusion, pressures for change exist and legislation will reflect these pressures. As bankers, you should recognize them and try to plan for them. It is difficult to fit in these longer-term forecasting problems when short-term problems seem overwhelming. Yet early recognition of the trends in the financial system will give you time to plan ahead to exploit the opportunity to offer new services by new methods. Look to the options open under the Bank Holding Company Act and be prepared for more vigorous competition from thrift institutions.

These changes will bring new legislation and problems of adapting, but they also will bring new opportunities. I think there will always be a role for the small bank to serve its community. American technology has always been flexible enough to serve the small firm, and with this help, you can count on the small bank playing a role in the coming payments system.



